

OPEN MEETING ITEM

COMMISSIONERS
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Executive Secretary
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ARIZONA CORPORATION COMMISSION

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DATE: OCTOBER 1, 2003

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DOCKET NO: E-01345A-02-0403

OCT 02 2003

TO ALL PARTIES:

ARIZONA CORPORATION COMMISSION
DIRECTOR OF UTILITIES

Enclosed please find the recommendation of Administrative Law Judge Lyn Farmer. The recommendation has been filed in the form of an Opinion and Order on:

**ARIZONA PUBLIC SERVICE COMPANY
(ADJUSTMENT MECHANISMS)**

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

OCTOBER 10, 2003

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

OCTOBER 21, 2003 and OCTOBER 22, 2003

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

Handwritten signature of Brian C. McNeil.
BRIAN C. MCNEIL
EXECUTIVE SECRETARY

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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MARC SPITZER, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 MIKE GLEASON

7 IN THE MATTER OF THE APPLICATION OF
8 ARIZONA PUBLIC SERVICE COMPANY FOR
9 APPROVAL OF ADJUSTMENT MECHANISMS.

DOCKET NO. E-01345A-02-0403

DECISION NO. _____

OPINION AND ORDER

9 DATE OF HEARING: April 3, (pre-hearing conference), April 7, and 8, 2003
10 PLACE OF HEARING: Phoenix, Arizona
11 ADMINISTRATIVE LAW JUDGE: Lyn Farmer
12 APPEARANCES: Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on
13 behalf of Arizonans for Electric Choice and
14 Competition;
15 Mr. Thomas L. Mumaw, PINNACLE WEST CAPITAL
16 CORPORATION, on behalf of Arizona Public Service
17 Company;
18 Mr. Scott S. Wakefield, Chief Counsel, on behalf of the
19 Residential Utility Consumer Office; and
20 Ms. Janet Wagner and Mr. Jason Gellman, Staff
21 Attorneys, Legal Division, on behalf of the Utilities
22 Division of the Arizona Corporation Commission.

23 **BY THE COMMISSION:**

24 On May 31, 2002, Arizona Public Service Company ("APS") filed with the Arizona
25 Corporation Commission ("Commission") an application for approval of rate adjustment
26 mechanisms.

27 On June 10 and 21, 2002, the Residential Utility Consumer Office ("RUCO") and Panda Gila
28 River, L.P. ("Panda") respectively, filed Motions to Intervene.

On July 16, 2002, RUCO and Panda were granted intervention.

On November 6, 2002, Arizonans for Electric Choice and Competition ("AECC") requested
intervention.

1 On August 30, 2002, the Utilities Division Staff ("Staff") of the Commission filed a Motion
2 to Suspend the Proceeding ("Motion"). The Motion requested suspension of the matter until the
3 completion of Track B of the Generic Proceeding Concerning Electric Restructuring. Staff stated that
4 its analysis of the adjustor might be affected by the outcome of Track B, and because APS cannot
5 benefit from its proposed adjustor mechanism until the conclusion of its next rate case, which would
6 not be filed until June 30, 2003, suspending the adjustor proceeding would not prejudice APS.

7 On September 9, 2002, RUCO filed its response in support of Staff's Motion.

8 On September 11, 2002, APS filed its response, stating it would not oppose a limited
9 extension of the deadline for completing the proceeding, but that it would not support an indefinite
10 suspension.

11 On September 23, 2002, Staff filed its reply requesting that the Commission suspend the
12 deadline and set the matter for hearing sometime in April, 2003. Staff believed that this matter could
13 then be concluded before the start of APS' next rate case.

14 On December 4, 2002, APS filed its supplemental response. APS stated that it no longer
15 opposed Staff's Motion and asked for a Procedural Order "suspending the December 31, 2002
16 'deadline' and setting an evidentiary hearing for sometime in April 2003."

17 On December 10, 2002, a Procedural Order was issued which granted intervention to AECC;
18 set the date for hearing to commence on April 7, 2003; and also listed deadline dates for the filing of
19 testimony, briefs, publication and discovery.

20 On January 17, 2003, APS filed proof of publication of notice of the application and hearing,
21 in compliance with the December 10, 2002, Procedural Order. APS published notice of the
22 application and hearing in the *Arizona Republic* on December 30, 2002, and also provided the notice
23 as a bill insert during its January and February billing cycles.

24 The hearing was held as scheduled on April 7 and 8, 2003, with Alan Proper, David Rumolo,
25 and Donald Robinson testifying on behalf of APS; Marylee Diaz Cortez testifying on behalf of
26 RUCO; Kevin Higgins testifying on behalf of AECC; and Linda Jaress, Barbara Keene, John
27 Thornton, and Erinn Andreasen testifying on behalf of Staff.

28 Post hearing Initial Briefs were filed on May 2, 2003 and Reply Briefs were filed on May 15,

1 2003.

2 INTRODUCTION

3 In Decision No. 61973 (October 6, 1999), the Commission adopted the APS Settlement
4 Agreement as modified. Section 2.6 of the Settlement Agreement provides that:

5 [n]otwithstanding the rate reduction provisions stated above, the Commission
6 shall, prior to December 31, 2002, approve an adjustment clause or clauses which will
7 provide full and timely recovery beginning July 1, 2004, of the reasonable and prudent
8 costs of the following:

9
10 (1) APS' 'provider of last resort' and Standard Offer obligations for
11 service after July 1, 2004, which costs shall be recovered only from
Standard Offer and 'provider of last resort' customers;

12 (2) Standard Offer service to customers who have left Standard Offer
13 service or a special contract rate for a competitive generation supplier but
14 who desire to return to Standard Offer service, which costs shall be
recovered only from Standard Offer and 'provider of last resort' customers;

15 (3) Compliance with the Electric Competition Rules or Commission-
16 ordered programs or directives related to the implementation of the Electric
17 Competition Rules, as they may be amended from time to time, which costs
18 shall be recovered from all customers receiving services from APS,
provided however, that no more than sixty-seven percent (67%) of the costs
to transfer generation assets to an affiliate or affiliates shall be allowed to
be deferred for future collection under this provision; and¹

19 (4) Commission-approved system benefit programs or levels not
20 included in Standard Offer rates as of June 30, 1999, which costs shall be
21 recovered from all customers receiving services from APS.

22 By June 1, 2002, APS shall file an application for an adjustment clause or
23 clauses, together with a proposed plan of administration, and supporting testimony.
24 The Commission shall thereafter issue a procedural order setting such adjustment
25 clause application for hearing and including reasonable provisions for participation by
26 other parties. The Commission order approving the adjustment clauses shall also
27 establish reasonable procedures pursuant to which the Commission, Commission Staff

28 ¹ From the Addendum to Settlement Agreement dated November 24, 1999.

and interested parties may review the costs to be recovered. By June 30, 2003, APS will file its request for the specific adjustment clause factors which shall, after hearing and Commission approval, become effective July 1, 2004.

Decision No. 61973 provided that: “[w]e concur that a PPA would result in less risk to the Company resulting in lower costs for the Standard Offer customers. As a result, we will approve the concept of the PPA as set forth in Section 2.6(1) with the understanding that the Commission can eliminate the PPA once the Commission has provided reasonable notice to the Company.” (Decision No. 61973 at page 12)

The proposed rate adjustment mechanisms include²:

1. a power supply adjuster (“PSA”) mechanism to recover the prudent and reasonable cost of providing power supplies for the Company’s Standard Offer and/or “provider of last resort” customers;
2. a returning customer direct assignment charge (“RCDAC”) to recover from direct access customers the additional costs, both one-time and recurring, that these customers would otherwise impose on other Standard Offer customers if and when the former return to Standard Offer service from their competitive suppliers;
3. a Systems Benefits adjustment clause (“SBAC”) rate mechanism that would permit the Commission to authorize the recovery of additional costs prudently and reasonably incurred by the Company for System Benefits programs authorized or required by the Commission under the provision of A.A.C. R14-2-1608; and
4. a Competition Rules compliance cost (“CRC”) rate adjustment mechanism that would permit APS to recover both the accumulated balance of prudent and reasonable costs (including return) incurred by the Company to comply with A.A.C. R14-2-1601, *et seq.* (“Electric Competition Rules”) and various Commission orders related to the implementation of such Electric Competition Rules.

Decision No. 56450 (April 13, 1989) ended APS’ Purchased Power and Fuel Adjustor

² As defined by the Company.

1 (PPFAC) and the Operating Incentive clause of APS.³ The Decision discussed the advantages and
2 disadvantages of the PPFAC, and concluded that fuel costs were stable and were expected to be
3 stable for the next few years; that the existence of the PPFAC causes piecemeal regulation which is
4 inefficient and undesirable; and that the disadvantages of the continuation of the fuel adjustor
5 outweigh any advantage.

6 In its testimony in this proceeding, Staff identified the following advantages and
7 disadvantages:

8 Advantages:

- 9 1. The reporting requirements and forecasts facilitate utility planning and Staff overview
10 of costs;
- 11 2. An adjustor that works correctly, over time, reduces the volatility of a utility's
12 earnings and the risk reduction can be reflected in the cost of equity capital in a rate case and
13 result in lower rates;
- 14 3. Adjustors can create price signals to consumers, but the effectiveness is reduced
15 considerably when a band is included and a twelve month rolling average is used;
- 16 4. Adjustors can help reduce the frequency of rate cases. But Staff notes that APS had
17 six rate cases in the ten years it had an adjustment clause before it was abolished, and only
18 one fully litigated rate case and three settlement agreements in the fourteen years since;
- 19 5. Regulatory lag between the incurrence of an expense and its recovery is reduced and
20 generational inequities are also reduced.

21 Disadvantages:

- 22 1. Adjustors can reduce incentives to minimize costs;
- 23 2. An adjustor that includes fuel or purchased power costs potentially biases capital
24 investment decisions towards those with lower capital costs and higher fuel costs;
- 25 3. Adjustors create another layer of regulation in addition to rate cases, increasing the
26 cost of regulation to the utility, its customers, and to the Commission;

27
28 ³ See Direct testimony of Staff witness Keene on the history of APS' adjustment clause, pp 3-4.

4. An adjustor can shift a disproportionate proportion of the risk of forced outages and systems operations from shareholders to ratepayers;

5. Adjustors result in piecemeal regulation – an adjustor reflects an increase in one expense but ignores offsetting savings in other costs;

6. Adjustors are complex and often difficult for analysts to read and interpret, and are difficult to explain to customers;

7. Proper monitoring of adjustor filings and audits require the devotion of significant Staff resources; and

8. Rates are less stable, resulting in rates changing frequently, making it difficult for customers to plan energy consumption and the purchase of energy consuming appliances.

POWER SUPPLY ADJUSTOR (PSA)

Discussion

APS' application proposes a Standard Offer adjustment mechanism which it calls a Power Supply Adjustor ("PSA"). The PSA is to be applied to Standard Offer customers to track the changes in APS' cost of obtaining power supplies. APS proposes to include not only purchased power costs, but fuel costs as well. The base power supply charge will be developed in the rate case, and then the actual costs will be compared to that level. The PSA includes four components: a monthly Power Cost Component Factor ("PCCF") charged to customers; a Balancing Account with a defined maximum threshold amount of \$50,000,000 (approximately one month's fuel and purchased power costs); a "band" that limits the amount of the PCCF that can be applied each time the PCCF is changed; and an Amortization Charge to reduce the size of the Balancing Account.

The PCCF is calculated by comparing the rolling twelve-month average power supply cost for fuel and power purchases to the base system average cost. The bandwidth is to be set each year in the first six month adjustment period using 5 percent of the prior calendar year's Annual Retail Revenue per kWh. The resulting bandwidth will be applied to the difference between the rolling twelve month average power supply cost and the base system average cost at the six month adjustment cycles, and will limit the increase or decrease in the PCCF. The Balancing Account serves two functions: it accumulates dollars associated with under-collection or over-collection from the application of the

1 PCCF due to timing differences; and will accumulate credits or debits due to the band limits in the
2 PCCF calculation. When the Balancing Account reaches its threshold, APS proposes that the balance
3 will be zeroed out and an energy-based charge will be created to amortize the balance over a one year
4 period. The Balancing Account will accrue interest at the three-month commercial rate. APS
5 proposes to make semi-annual informational filings containing all calculations regarding the PSA and
6 including a revised tariff sheet with the new PCCF. Commission action would be required only when
7 APS files to establish or revise an Amortization Charge.

8 Staff testified that it saw no compelling reason to adopt the APS proposed adjustor and
9 surcharge mechanisms at this time, and believes that the pending APS rate case is a better forum for
10 constructing and implementing the mechanisms, so that their effect on customers can be determined.
11 Staff believes that APS' proposed mechanisms are not vital to its operations nor to its financial
12 health, and so are not necessary at this time. Staff believes that at the time the Commission approved
13 the Settlement Agreement, it expected that APS would be purchasing all of its power and that a
14 significant impact may occur to APS' financial well being without an adjustor. Since the
15 Commission's Decision No. 65154 (Track A) stopped APS' divestiture, that expectation has not
16 materialized. Staff believes that because Decision No. 61973 approved the "concept" of an adjustor,
17 rather than approving and implementing a specific adjustor, the "Commission has wide latitude to
18 develop an adjustment mechanism that suits the current facts and circumstances." Staff Initial Brief,
19 at 11-12.

20 Although Staff expressed reservations about the necessity for APS' proposed adjustor
21 mechanism, based on the provisions of the 1999 Settlement Agreement as well as its review of the
22 proposed PSA, Staff does not believe adoption of a PSA would harm the public interest, subject to
23 inclusion of the conditions described herein. Because Decision No. 61973 did not contemplate
24 recovery of fuel costs in the adjustor, Staff recommends that if an adjustor is approved, the
25 Commission should include fuel costs in the PSA in order to prevent APS from skewing its
26 procurement decisions. Staff states that an adjustment mechanism that does not include fuel may
27 encourage APS to purchase power rather than run its existing units, even though it may be cheaper to
28 run the existing units, and that it may cause APS to schedule unit maintenance without considering

the costs in the context of timing. According to Staff, the “danger is that the utility may base its operational decisions upon ease of cost recovery rather than the underlying economics, thereby resulting in higher costs to ratepayers.” Staff Initial Brief at 12.

Based upon its review of the provisions of the 1999 Settlement Agreement and the PSA, Staff believes that the PSA, subject to the following conditions, would not harm the public interest:

1. The PSA should expire three years from its effective date, and nine months prior to the expiration, APS could file for an extension and the Commission could review the PSA mechanism;
2. The Commission should reserve the right to review the prudence of fuel and power purchases at the time of the above review or at any time;
3. The Commission should reserve the right to review any calculations associated with the PSA at any time;
4. There should be an earnings test attached to the PSA to prevent APS from passing on rate increases if it is already earning an appropriate rate of return;
5. Any costs flowed through the PSA should be subject to refund if costs were found later not to be prudently incurred;
6. The amortization period for an amortization charge should not be determined at this time;
7. APS should file monthly reports to the Director of the Utilities Division;
8. APS should file additional monthly reports confidentially with Staff;
9. APS should keep all contracts and invoices for fuel and purchased power;
10. Reduction of risk should be considered in the cost of equity in APS’ next rate case;
11. The bandwidth limit should be set at \$0.004 (4 mills) per kWh; and
12. The rate case decision should require APS to file a plan with Staff for providing notice to customers about the PSA charge and any rate changes resulting from the case.

Condition #1

APS opposes several of Staff’s conditions, including Condition #1 which requires the PSA to end after three years unless APS takes action to request its continuance. APS believes that the Staff recommendation provides no safeguards or guidelines on how due process requirements would be met, or what would happen with existing bank balances and how to reintegrate the PCCF into the base rates. APS believes that three years is not enough time to evaluate the PSA’s merits. In response, Staff states that APS has not shown that the adjustment mechanisms are vital to its operations or to its financial health and “has instead relied upon the simple fact that the Commission has approved its settlement agreement, even though facts surrounding that approval are vastly

different from the facts today.” Staff Initial Brief at 3. Staff testified that it is very difficult to design an adjustment mechanism correctly, and that circumstances change and modifications will be likely.

Conditions #2& 3

APS also opposes Condition #2’s provision that the Commission is not limited as to when it may conduct a prudence review. APS argues that there should be a limit on how far back the Commission can go and make retroactive adjustments and suggests six months. Staff believes that APS’ proposed six month or one year limit on the Commission’s ability to review APS’ use and implementation of the PSA puts ratepayers at risk.

Condition #4

APS opposes Staff’s Condition #4 which limits increases in fuel and purchased power costs by application of an “earnings test.”

Staff recommends that the Commission adopt an earnings test to ensure that APS collects just and reasonable rates. Staff believes that allowing APS to increase its PSA rates when it is earning over an established benchmark return on equity would constitute a windfall gain at the expense of ratepayers. Staff recommends that APS’ PSA be designed so that it cannot increase rates (base tariff plus the PSA) if such an increase reflects over-earning. APS argues that the earnings test is not symmetrical, but Staff responds that the asymmetry is intended as a “relief valve” to minimize the harm to ratepayers, as APS would not voluntarily apply for a rate decrease when it is over earning, but would apply for an increase when it is under earning. Staff testified that its “earnings test” is in response to the Commission’s request of Staff to review the necessity and application of adjustment mechanisms, and ways to improve them. Staff believes that its earnings test will significantly improve the adjustment mechanism by helping to insure that APS does not reap windfall profits at the expense of ratepayers.

APS argues that such an earnings test is unprecedented in this jurisdiction; would cause significant accounting and financial reporting issues; would be cumbersome to implement; and is unfair in its one-sidedness. In response, Staff states that just because the earnings test has not been used previously is not a reason to reject it; that deferrals and disallowances are common regulatory actions and no other jurisdiction has encountered such problems; the Commission only needs to adopt

1 the concept and the details can be worked out in the rate case; and the earnings test results in a more
2 fair PSA because if APS is earning a healthy return on equity for its shareholders, then it should not
3 pass on rate increases to its ratepayers. Staff presented an exhibit showing a graph depicting APS'
4 quarterly return on common equity from June 2000 to September 2002. (Exhibit S-6, JST-2) APS'
5 return peaked at 16.3 percent, and Staff questions a PSA that would allow rate increases while APS is
6 earning a 16.3 percent return. According to Staff, the PSA that APS proposes would pass along cost
7 increases, unchecked. Staff's earnings test concept is designed to put a check on adjustor increases.
8 Staff believes that an earnings test is critical in order to ensure just and reasonable rates.

9 APS argues that Staff's earnings test is unlawful under *Arizona Community Action Assoc. v.*
10 *Arizona Corporation Commission*, 123 Ariz. 228, 559 P.2d. 184 (1979) because it ties a rate
11 mechanism to the Company's earned return on common equity. According to APS, no other
12 jurisdiction uses the earnings test as proposed by Staff. APS believes that the earnings test would
13 "accentuate the very earnings instability the PSA is intended to ameliorate and may cause the very
14 'over earning' that Staff appears to fear." APS Initial Brief at 17. APS also argues that the earnings
15 test is impractical because it would force a "mini-rate case" every six months, thereby eliminating
16 one of the benefits of an adjustor.

17 APS believes that Staff's proposed earnings test is a violation of the APS Settlement
18 Agreement because it will not allow for the "full and timely recovery" of the reasonable and prudent
19 costs.

20 In response to APS' *Arizona Community Action* argument, Staff argues that the case actually
21 holds that the Commission may not base a rate increase solely on a single criterion that places
22 shareholders' interests above ratepayers' interests. Staff differentiates its earning test because it is
23 not a single tariffed rate; no recovery will be allowed unless the fuel and purchased power expenses
24 are reasonable and prudent; and because it is designed to protect ratepayers.

25 Condition #6

26 APS opposed Staff's Condition #6 which allows the Commission to determine the appropriate
27 amortization period on a case by case basis. APS argues that the Commission should establish a one-
28 year period for amortization, subject to the ability of APS or other parties to request a different time

1 period. Staff opposes a “one-size-fits-all” amortization time period. It believes that the size of the
2 amount to be amortized and other factors should be considered when determining an appropriate
3 amortization period. Establishing an amortization period without knowing or considering the
4 magnitude of the amount to be amortized may lead to significant rate increases. Staff recommends
5 that the Commission determine the amortization period on a case by case basis.

6 Other Conditions

7 Concerning Staff’s Condition # 10, which is that a reduction in risk should be considered in
8 the cost of equity in APS’ rate case, APS does not believe that there would be any such risk reduction
9 due to Staff’s three year automatic “sunset” of the PSA and the Staff recommended “earnings test”,
10 but does not disagree in principle that consideration of risks is appropriate in a rate proceeding.

11 Although APS proposed a percentage cap, it did not oppose Staff’s Condition #11’s 4
12 mill/kWh “bandwidth limit” because the two are roughly equivalent.

13 APS agreed with Staff Conditions #7, 8, and 12.

14 Fuel Costs in PSA

15 APS believes that an adjustor mechanism is appropriate for its purchased power and fuel costs
16 because they constitute an expense that is very large compared to its total operating costs, they are
17 very volatile, and very unpredictable. APS argues that “by 2004, the first year for which the PSA
18 would be effective, fuel and purchased power will account for 40% of APS operating costs. And gas
19 and purchased power, the two most volatile and unpredictable components of power supply costs,
20 will constitute 60% of total fuel and purchased power expense.” APS Initial Brief at 12. APS states
21 that the fuel used by virtually all new generation in the West is natural gas, and the Company’s
22 dependence on “these two volatile power supply elements (gas and purchased power) can only grow
23 in the years after 2004.” Id. at 13 APS believes that the inclusion of gas is “clearly justified given its
24 significance to overall utility costs now that Decision No. 65154 has halted divestiture, its volatility
25 (both presently and historically), and its interchangeability with purchased power in meeting the
26 power supply needs of Standard Offer customers.” Id. at 14.

27 APS recognizes that Decision No. 61973 and the Settlement Agreement do not specifically
28 mention fuel with reference to the PSA, but point out that the Settlement Agreement mentions “full

1 and timely” recovery of prudent and reasonable costs.

2 Although Staff agreed that gas prices are volatile and that natural gas now makes up a larger
3 percentage of APS’ fuel portfolio, Staff recommends that fuel be included in the PSA primarily
4 because Staff believes that it would prevent the Company’s operational decisions from being
5 inappropriately skewed.

6 RUCO Recommendation

7 RUCO recommends denying the PSA, arguing that although the Settlement Agreement
8 originally contemplated an adjustor mechanism for purchased power costs, it is no longer necessary
9 in light of the Commission’s Track A Decision. RUCO argues that a “primary purpose of the 1999
10 Settlement Agreement has been frustrated by the failure of the wholesale market to develop.” RUCO
11 Initial Brief at 9. RUCO also states that the Settlement Agreement’s adjustor mechanism did not
12 include fuel costs. Therefore, RUCO concludes that the Commission is not obligated to implement
13 the PSA. Because the costs that the PSA would recover are not volatile; because the impact of APS’
14 purchased power costs will be far less than what was contemplated under the Settlement Agreement;
15 because of the potential for piecemeal ratemaking; and because fuel costs do not meet the standard
16 for an automatic adjustment mechanism, RUCO believes the Commission should deny the PSA.

17 AECC Recommendation

18 AECC does not support the PSA proposed by APS. AECC believes that the Settlement
19 Agreement provided for a PSA allowing APS to recover only its purchased power costs. AECC’s
20 witness testified that the PSA was to be used to recover wholesale purchase power costs, not costs
21 associated with a vertically integrated utility. AECC believes that any adjustor approved in this order
22 should not include costs other than purchased power costs, and that fuel costs should be addressed in
23 APS’ pending rate case.

24 AECC argues that APS’ proposal to include fuel costs lacks important details regarding the
25 treatment of wholesale sales. According to AECC, the formula proposed by APS does not back out
26 the energy and fuel costs associated with wholesale transactions, and it does not properly separate
27 wholesale and retail transactions. AECC believes that this supports its recommendation not to
28 include fuel costs in a PSA at this time, but to consider it in the rate case. Additionally, AECC argues

1 that the Commission cannot establish an adjustor clause outside of a rate case in light of *US West*
2 *Communications Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 34 P.3d 351 (2001) and *Residential*
3 *Utility Consumer Office v. Arizona Corp Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001). The
4 AECC recommends that since the costs and charges to be included in the adjustment mechanism are
5 not to be determined until the rate case, the Commission should defer the adoption of the adjustment
6 mechanisms to the rate case, when all factors such as costs, allocation of costs, risk to the customer
7 and company, and the appropriate rate of return can be taken into consideration. The AECC
8 recommends that the rate case address maintaining incentives for fuel cost minimization, recognizing
9 a wholesale revenue credit, and ensuring that none of the costs associated with provision of Standard
10 Offer service before July 1, 2004 are rolled forward into the adjustor mechanism. AECC
11 recommends that the Commission approve any changes in the PSA rates, and that APS' PSA should
12 consider customer class differences in line losses and off-peak energy use, and apply an equal
13 percentage change on the generation cost component for each customer.

14 Analysis

15 Under traditional regulatory ratemaking, a utility has incentive to keep its expenses under
16 control, so that it has the opportunity to earn its authorized rate of return. Under some circumstances,
17 public utility commissions have departed from the traditional ratemaking methodology when
18 circumstances sufficiently warrant unusual treatment. One such treatment is the implementation of
19 adjustor mechanisms. This departure from traditional regulatory treatment is adopted usually for one
20 or more of the following reasons: the expense is outside the direct control of the utility; the expense
21 represents a large percentage of the utility's operating costs; and because the cost is volatile. The
22 purpose of the adjustor is to prevent this expense from adversely affecting the utility's financial
23 ability to provide adequate service to its customers.

24 Here, APS argues that its adjustors should be approved because the Commission adopted a
25 Settlement Agreement that provided for the adjustors. APS argues that even if the Settlement
26 Agreement did not explicitly include fuel costs, fuel cost should be included in the adjustor, because
27 its fuel costs are volatile and are an increasing portion of its overall expenses. Staff believes that APS
28 has not justified the need for adjustors, but recognizes that Decision No. 61973 adopted the concept

1 of a purchased power adjustor, and so recommended conditions that it believes would result in no
2 harm to the public interest.

3 We agree with Staff that Condition #1, which requires APS to request continuance of the PSA
4 prior to its otherwise automatic termination at three years, is reasonable. Although APS posed
5 potential procedural concerns, we believe that those can be addressed at the time a request for
6 extension is made. Staff has indicated that any procedure that will provide for a meaningful review
7 of the PSA would be acceptable to Staff. Additionally, at the time of the request for continuance,
8 there will be over two years of actual experience with the PSA which we believe is adequate time to
9 evaluate its merits.

10 We also agree with Staff that Condition #2 is appropriate. The use and implementation of the
11 PSA will create additional regulatory duties for Staff and will require significant review and audit
12 time. We do not think it is reasonable to limit our Staff's or our ability to insure that the rates passed
13 through the PSA are reasonable and appropriate. Any objections to "stale" data or evidence can be
14 made and considered in the context of the review. It is reasonable that in exchange for the ability to
15 quickly pass the costs through the PSA, that the review period of those costs not be limited.

16 Staff's Condition #6 is also reasonable. Setting an amortization period without knowing the
17 amount of dollars involved invites problems. Usually when setting an amortization charge, the
18 Commission considers not only the amount, but also the time period over which the amount
19 accumulated, and also perhaps the season during which it will be collected. Although a set one year
20 period may provide certainty to APS, it does not provide for the flexibility we need in order to insure
21 that the rates are reasonable and appropriate in a given case.

22 Condition #4 is the most controversial condition recommended by Staff. It is an earnings test,
23 which is designed, essentially, to limit the adjustor's ability to pass along rate increases when the
24 utility is already earning a healthy rate of return. Although APS argues that such an earnings test
25 would violate the "full and timely recovery" of the "reasonable and prudent costs", the situation is
26 really no different than the Company's ability to recover any of its costs. Decision No. 61973 did not
27 fully adopt all provisions of the Settlement Agreement, and it specifically stated that the reason the
28 adjustor mechanism in Section 2.6(1) was being approved was based upon concurrence with APS that

1 a purchased power adjustor (PPA) would result in less risk to the Company, resulting in lower costs
2 for the Standard Offer customers. It appears now that one reason APS wants the PSA is to increase
3 costs to Standard Offer customers, even when its other expenses decrease. Further, the Commission
4 explicitly stated that the PPA was approved with the understanding that the Commission can
5 eliminate the PPA once the Commission has provided reasonable notice to the Company. (Decision
6 No. 61973 at 12). Accordingly, we approve the PSA with the Staff conditions, including adoption of
7 Staff's earning test to be developed during the rate case. However, APS is placed on notice that the
8 PSA may be eliminated during the pending APS rate case.

9 We believe that under Decision No. 61973, we are not bound to approve the PSA as presented
10 by APS, as it is not a PPA as the Commission approved in "concept" in that Decision. Further, the
11 Commission did not approve fuel to be included in the PPA. However, Staff made a strong argument
12 in favor of including fuel costs in order to prevent the utility from making supply decisions based
13 upon ease of cost recovery. Although we are inclined to include such costs, we believe that the rate
14 case should further address the issue and the issues raised by AECC concerning maintaining
15 incentives for fuel cost minimization, proper recognition of a wholesale credit, and how to insure
16 none of the costs associated with provision of Standard Offer service before July 1, 2004 are rolled
17 forward into the adjustor mechanism.

18 Accordingly, we are willing to give the parties the opportunity to attempt to work on an
19 adjustor that would minimize the risk to both APS and the ratepayers. APS has indicated its "strong"
20 support for "performance based regulation ("PBR")" and willingness to look at alternatives to Staff's
21 earnings test. Rejoinder testimony of Donald Robinson at 12. Further refinement of an earnings test
22 or a form of PBR can take place in the rate case and can comply with *Arizona Community Action*.

23 On the issue of whether we can establish an adjustor outside of a rate case, the AECC
24 discussed two Arizona cases decided after we issued Decision No. 61973. According to the AECC,
25 *US West Communications Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242 requires a fair value
26 determination of a utility's property in connection with establishing rates, and *Residential Util.*
27 *Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 592 (App.2001) holds that "an adjustment
28 clause can be set 'only after a full rate hearing' 199 Ariz. at 592" AECC Initial Brief at 5. Staff

1 stated in its Initial Brief that although that case “would appear to hold that the Commission cannot
 2 establish an adjustment mechanism outside of a rate case”, it “does not address whether the
 3 Commission could establish an adjustment mechanism in a proceeding that included a fair value
 4 finding but was less than a full rate case. This is still an open question under Arizona law.” Staff
 5 Initial Brief at 9. Staff concludes that the issue of whether the Commission can create an adjustor
 6 outside of a rate case is not presented in this proceeding, because the adjustor and surcharge
 7 mechanisms will not take effect until the conclusion of the pending rate case. We agree.

8 **RETURNING CUSTOMER DIRECT ASSIGNMENT CHARGE (RCDAC)**

9 APS proposes an RCDAC that would collect from an individual or aggregate group of
 10 customers who return(s) to APS Standard Offer service after having been served by a competitive
 11 supplier. The RCDAC applies only to larger customers and would reflect the additional costs of
 12 serving the returning customers.

13 Staff does not oppose the RCDAC with the following conditions:

- 14 1. The RCDAC tariff should specify that the charge will be applicable only to individual
 15 customers or aggregated groups of customers of three MW or greater;
- 16 2. The RCDAC tariff should indicate that a customer will not be subject to the RCDAC
 17 if he provides APS with one year’s advance notice of his intent to take Standard Offer service;
- 18 3. APS should break down the individual components of the potential charges on the
 19 RCDAC tariff, define them, and provide a general framework that describes the way in which
 20 the RCDAC will be calculated;
- 21 4. APS should file a revised Schedule AP-2 for Staff review prior to its implementation;
- 22 5. The RCDAD and Schedule AP-2 should not be effective until the conclusion of APS’
 23 upcoming rate case.

24 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover
 25 generation costs related to returning large customers and that the amount to be recovered and the
 26 timeframe for recovery should be determined in the pending rate case. AECC did not oppose the
 27 RCDAC.

28 APS did not agree that the tariff should include all costs that returning customers might face

1 because it believes that it is not practical or possible to identify all costs until the time when the
2 customer actually returns. APS does not agree with Staff that it should be precluded from seeking a
3 direct assignment of other costs to a returning customer under other circumstances on a case by case
4 basis. Staff argues that although the precise costs may not be determinable in advance, the types of
5 costs that may be incurred could be described, and tariffs should provide customers with reasonable
6 notice of its terms and not allow the utility to load on additional costs not clearly contained in its
7 tariffs. Staff recommended that APS be required to modify its RCDAC to reflect all possible costs of
8 returning to Standard Offer service and to prevent a RCDAC on customers who give at least one
9 year's notice of intent to return to Standard Offer service.

10 We believe that Staff's recommendation on the RCDAC is appropriate. Customers should
11 have notice of the types of costs that may be incurred, so that they can plan accordingly.

12 **SYSTEMS BENEFITS ADJUSTMENT CHARGE (SBAC)**

13 APS proposed a "placeholder" SBAC that allows it to pass through a charge to cover costs of
14 any future Commission-approved System Benefit programs that are not included in the Company's
15 base rates. Staff believes that it is premature to authorize approval of a surcharge mechanism to
16 recover costs of programs that have not been developed. In response to APS' argument that the
17 SBAC was mandated by Decision No. 61973 and the Settlement Agreement, Staff argues that it was
18 anticipated that APS would have proposed actual tariffs or programs in conjunction with the
19 mechanism, and that absent such specific proposals or plan of administration, there is nothing to
20 evaluate. Staff believes that because any Commission order evaluating future programs would
21 contain all the necessary authorizations for rate recovery and would determine how the new System
22 Benefits costs would be collected, the SBAC serves no present purpose. Staff further notes that APS
23 cannot bypass the fair value requirement of the Constitution by establishing a "placeholder"
24 surcharge mechanism – if and when the Commission authorizes new System Benefit rates, the fair
25 value requirement must be satisfied.

26 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover
27 System Benefits costs and that the amount to be recovered and the timeframe for recovery should be
28 determined in the pending rate case. The AECC did not oppose the SBAC.

1 Although the Settlement Agreement provided for an SBAC, APS did not file a plan of
2 administration or propose any programs or tariffs. However, we do not see any harm in creating an
3 SBAC at this time, as any recovery under this surcharge will only be allowed after we have reviewed
4 and approved the program, determined how the new System Benefits charge would be collected, and
5 after satisfying the fair value requirement. Accordingly, we will approve the SBAC with the
6 understanding that the above items will be complied with prior to any collections.

7 **COMPETITION RULES COMPLIANCE COST (CRC)**

8 The CRC is a means for APS to recover its costs associated with its transition to competition
9 and includes costs incurred from 1999 through 2004 to comply with the Commission's Electric
10 Competition Rules. APS proposes that the total amount to be recovered would be determined in the
11 rate case and recovered through an amortization charge over the next five years.

12 Staff recommended that the review of the CRC be included in the pending rate case because it
13 is difficult to determine the proper amortization period without knowing the size of the amount to be
14 recovered. Accordingly, Staff recommends that the Commission consider the design and other
15 aspects of the CRC in the pending rate case.

16 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover
17 costs incurred to transition to competition and that the amount to be recovered and the timeframe for
18 recovery should be determined in the pending rate case.

19 The AECC did not oppose the CRC, but disagrees with including Regional Transmission
20 Organization ("RTO") related costs in the adjustor, stating that APS should seek approval from
21 FERC for recovery of these costs in transmission rates. APS states that there is no need to determine
22 now what costs will be recovered through the CRC mechanism, but APS does believe that RTO
23 formation is "within the scope of costs that the Commission indicated in the APS Settlement would
24 be recovered in the CRC mechanism" APS Initial Brief at 8.

25 We agree with Staff that the review of the CRC should occur in the rate case, as the
26 appropriate level of costs to be recovered will be determined there. The issue of inclusion of RTO
27 costs should also be addressed then. We are adopting a CRC at this time, but the specifics of the
28 surcharge will be determined later, during the pending rate case where they can be evaluated in

context of the size of the amount to be recovered.

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. APS is a public service corporation engaged in furnishing electricity in the State of Arizona. APS provides either retail or wholesale electric service to substantially all of Arizona, with the major exception of the Tucson metropolitan area and about one-half of the Phoenix metropolitan area. APS also generates, sells and delivers electricity to wholesale customers in the western United States.

2. On May 31, 2002, APS filed an Application for Approval of Rate Adjustment Mechanism.

3. Notice of the application was provided in accordance with the law.

4. Intervention was granted to RUCO, AECC, and Panda.

5. The hearing was held on April 7 and 8, 2003. Briefs were filed on May 2 and 15, 2003.

6. In Decision No. 61973 (October 6, 1999), the Commission adopted the APS Settlement Agreement as modified.

7. The Settlement Agreement stated that the Commission would approve adjustor mechanisms for recovery of four categories of costs.

8. Decision No. 61973 provided that: "[w]e concur that a PPA would result in less risk to the Company resulting in lower costs for the Standard Offer customers. As a result, we will approve the concept of the PPA as set forth in Section 2.6(1) with the understanding that the Commission can eliminate the PPA once the Commission has provided reasonable notice to the Company."

9. APS' requested rate adjustor mechanisms include a PSA, an RCDAC, an SBAC, and a CRC.

10. The requested rate adjustor mechanisms would become effective upon the conclusion of the Company's pending rate case.

1 11. There are both advantages and disadvantages of implementing purchased power/fuel
2 adjustor mechanisms.

3 12. Although Staff testified that APS' proposed adjustor mechanisms are not vital to APS
4 operations or to its financial health, Staff recommended that approval of a PSA that includes fuel
5 costs and also includes 12 conditions would not harm the public interest.

6 13. The PSA presented by APS is not the PPA "concept" that the Commission approved
7 in Decision No. 61973.

8 14. According to Staff, if fuel costs are not included in the PSA, the utility may base its
9 operational decisions upon ease of cost recovery rather than the underlying economics, and thereby
10 increase costs to ratepayers.

11 15. The earnings test proposed by Staff is intended to insure that APS collects just and
12 reasonable rates, and would protect ratepayers by preventing a windfall to APS if it were allowed to
13 collect increases in the PSA when it is already earning over an established benchmark return on
14 equity.

15 16. According to Staff, the earnings test is asymmetrical because it is a "relief valve" to
16 minimize the harm to ratepayers, as APS would not voluntarily apply for a rate decrease when it is
17 over earning.

18 17. The concept of an earnings test has merit and should be explored further, together with
19 other options to reduce risk to ratepayers and shareholders, in the pending rate case.

20 18. The use of an earnings test does not violate the Settlement Agreement, as APS will
21 have the opportunity to recover costs and earn a return on fair value rate base that is just and
22 reasonable.

23 19. Although fuel costs were not included in the PPA concept we adopted in Decision No.
24 61973, the PSA adopted herein should include fuel costs for the reasons identified by Staff. This
25 issue should be further developed during the pending rate case.

26 20. AECC's recommendations concerning maintaining incentives for fuel cost
27 minimization, proper recognition of a wholesale credit, and how to insure none of the costs associated
28

1 with provision of Standard Offer service before July 1, 2004 are rolled forward into the adjutor
2 mechanism, are reasonable and should be adopted.

3 21. Staff's twelve conditions to the PSA, as discussed herein, are reasonable and should be
4 adopted.

5 22. The RCDAC with the conditions proposed by Staff should be adopted.

6 23. The SBAC proposed by APS, and as to be developed and modified by in the pending
7 rate case and in subsequent Commission decisions, should be approved.

8 24. The CRC should be adopted but the design and other aspects will be determined
9 during the pending rate case where they can be evaluated in context of the size of the amount to be
10 recovered.

11 CONCLUSIONS OF LAW

12 1. Arizona Public Service Company is a public service corporation within the meaning of
13 Article XV, Section 2 of the Arizona Constitution.

14 2. The Commission has jurisdiction over APS and of the subject matter of the instant
15 proceeding.

16 3. The adjustment mechanisms/surcharges should be approved with the modifications
17 made herein.

18 4. APS' PSA proposal in this docket is not the PPA concept approved in Decision No.
19 61973.

20 5. APS is given notice pursuant to Decision No. 61973 and A.R.S. § 40-252 that the PSA
21 approved herein may be modified or eliminated in the pending rate case.

22 6. It is just and reasonable that the adjutor mechanisms/surcharges approved herein may
23 be modified in APS' rate case and will become effective upon the Commission's decision in that
24 docket.

25 ORDER

26 IT IS THEREFORE ORDERED that Arizona Public Service Company's request for a Power
27 Supply Adjuster, as modified herein and in the order to be issued in the pending rate case, Docket No.
28 E-01345A-03-0437, is approved.

1 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a Returning
2 Customer Direct Assignment Charge, as modified herein, is approved.

3 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a System
4 Benefits Charge mechanism, as modified herein and in any subsequent Commission decision
5 approving a system benefit to be recovered through such mechanism, is approved.

6 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a
7 Competition Rules Compliance Charge, as to be determined in the pending rate case, is approved.

8 IT IS FURTHER ORDERED that the adjustment mechanisms/surcharges approved herein
9 and as subsequently modified, will become effective upon the conclusion of Arizona Public Service
10 Company's pending rate case.

11 IT IS FURTHER ORDERED that Arizona Public Service Company shall comply with all the
12 conditions as adopted herein.

13 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

14 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

15
16
17 CHAIRMAN

COMMISSIONER

COMMISSIONER

18
19 COMMISSIONER

COMMISSIONER

20 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
21 Secretary of the Arizona Corporation Commission, have
22 hereunto set my hand and caused the official seal of the
23 Commission to be affixed at the Capitol, in the City of Phoenix,
24 this ____ day of _____, 2003.

24 BRIAN C. McNEIL
25 EXECUTIVE SECRETARY

26 DISSENT _____

27 DISSENT _____

28 LAF:dap

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